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CorpFin Staff Issues Guidance on Disclosure Considerations for Chinese Issuers

On November 23, 2020, the Staff of the SEC's Division of Corporation Finance (the "Staff") issued CF Disclosure Guidance Topic No. 10 ("CF-10") (available here) setting forth its views regarding certain disclosure considerations for companies based, or with the majority of their operations, in China. In the CF-10 guidance, the Staff discusses the key risks associated with investments in China-based issuers, summarizes certain differences between the U.S. and Chinese legal frameworks relating to shareholder rights, corporate governance and reporting, and highlights disclosure considerations for China-based issuers.

The Staff issued the CF-10 guidance in the context of the long-running conflict between the Public Company Accounting Oversight Board ("PCAOB") and Chinese authorities over access to audit work papers maintained in China by PCAOB-registered accounting firms that audit the financial statements of SEC reporting companies and the ability of the PCAOB to conduct on-site inspections of audit work and practices of these accounting firms. These issues and related disclosure, financial reporting and other risk considerations were highlighted, for example, in a joint statement issued by SEC Chairman Jay Clayton, the PCAOB Chairman William D. Duhnke III and other senior staff of the SEC in April 2020 (available here). In the political arena, Congress has considered legislation to address the PCAOB access issue[1] as has President Trump[2] and his Working Group on Financial Markets. On August 6, the Working Group released a report with recommendations for China-based issuers and for addressing the issue of PCAOB access and investor protections more broadly (see our August 7 client alert available here). One of the Working Group's recommendations called for enhanced issuer disclosures of the risks for companies located in so-called non-cooperating jurisdictions, including China, either through rulemaking or interpretive guidance. The CF-10 guidance appears to be a response to that recommendation.

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[1] *See* The Holding Foreign Companies Accountable Act (available here) passed by U.S. Senate on May 20 that could result in the delisting of non-U.S. reporting companies (particularly from China) whose financial statements have, for a period of three consecutive years, been audited by an accounting firm branch or office that is not subject to PCAOB inspection.

[2] *See* our June 8 client alert (available here) discussing President Trump's Memorandum directing his Working Group to prepare a report on addressing the issues related to PCAOB and China-based issuers.

Risks Associated with China-based Issuers

The Staff notes that, while the risks highlighted in the CF-10 guidance may apply to foreign private issuers generally or issuers operating in emerging jurisdictions, these risks, in its view, are particularly significant in relation to China-based issuers. In particular, the Staff cites the following risks:

- *Risks Related to High-Quality and Reliable Financial Reporting.* The Staff highlights the significant risk resulting from the continued inability of the PCAOB to access and inspect audit work of PCAOB-registered public accounting firms in China and Hong Kong in order to assess their compliance with auditing standards. The legislative proposals currently pending in the U.S. House of Representatives and the U.S. Senate aimed at addressing this issue could, if adopted, have an adverse impact on trading prices of securities or terminate the trading of securities of China-based issuers audited by PCAOB-registered firms in China and Hong Kong.

- *Risks Related to Access to Information and Regulatory Oversight.* Due to the restrictions imposed by Chinese law[3] on the ability of U.S. regulators to obtain documents and information on China-based issuers in order to gather evidence and conduct investigations, the effective enforcement of U.S. federal laws against China-based issuers and their officers and directors, on behalf of U.S. investors, has been, and remains, significantly curtailed.

- *Risks Related to a Company's Organizational Structure.* The Staff notes the significant risks posed by the use of variable interest entity (VIE) structures[4] by China-based issuers in order to circumvent limitations or prohibitions on foreign investment in certain industries under Chinese regulations. The risks associated with VIE structures include: (i) China-based issuers' exercise of control over a VIE entity through contractual arrangement being less effective than control via direct equity ownership; (ii) the ability of the Chinese government to declare VIE structures non-compliant with Chinese law and regulations that could lead to penalties, revocation of business and operating licenses and forfeiture of ownership interests for China-based issuers; and (iii) the control over a VIE being jeopardized if any natural person holding the equity interests in the VIE is subject to legal proceedings or if any physical instruments (such as chops and seals) are used to enter into contractual agreements without the authorization of the China-based issuer.

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[3] Article 177 of the PRC Securities Law prohibits overseas securities regulators from directly conducting investigations or engaging in evidence collection activities within China, and entities and individuals in China from providing documents and information relating to securities business activities to overseas regulators without Chinese government approval.

[4] A VIE structure involves a China-based issuer forming a non-Chinese holding company that enters into a contractual relationship with a Chinese operating company (known as a variable interest entity or VIE), allowing the China-based issuer to consolidate the VIE in its financial statements.

- *Risks Related to the Regulatory Environment.* As a result of major differences between the legal systems in China and the United States, the operations of China-based issuers are subject to a high degree of uncertainty relating to the intent, effect and enforcement of applicable laws and regulations (including those that restrict flow of foreign capital into China or permit the Chinese government to affect the ability of China-based issuers to conduct business or raise capital). The potential inconsistent and unpredictable interpretation and enforcement of laws may negatively affect the issuers' ability to conduct their operations (China-based issuers may be unable to obtain the required permits and licenses) and result in material sanctions and penalties for the issuers.

Differences in Shareholder Rights and Recourse, Governance, and Reporting Associated with China-based Issuers

The Staff highlights the key differences between Chinese and U.S. regulatory regimes affecting issuers.

- *Limitations on Shareholder Rights and Recourse.* The Staff notes that U.S. investors' ability to bring claims and obtain judgments in U.S. courts and enforce judgments against China-based issuers may be difficult due to majority of such issuers' assets or persons often being located outside the United States in jurisdictions that may not recognize or enforce U.S. judgments. Pursuing claims or remedies outside the U.S. judicial system may also be limited and difficult due to significant differences in claims and remedies available in China and other overseas jurisdictions.

- *Corporate Governance Differences.* China-based issuers are often organized in jurisdictions other than United States and China with different corporate law and corporate governance rules and practices that may result in limited shareholder protections and additional material risks. For example, in many jurisdictions directors' fiduciary duties are narrower in scope or less developed than in the United States. Moreover, the fact that many (although not all) China-based issuers qualify as foreign private issuers will result in these issuers being subject to less demanding corporate governance requirements as compared to U.S. domestic issuers.

- *Reporting Difference.* China-based issuers that qualify as foreign private issuers are exempt from certain reporting requirements, such as quarterly reports and certifications by principal executive and financial officers, current reports on Form 8-K, solicitations of proxies, reporting requirements for company insiders and Regulation FD, which may present increased risks for investors.

Disclosure Considerations for China-based Issuers

The Staff suggests that the following questions be considered by China-based issuers when assessing the material risks related to their operations in China and their related disclosure obligations:

- Does the company provide clear and prominent disclosure of PCAOB inspection limitations and lack of enforcement mechanisms, as well as the risks relating to the quality of the financial statements? Specifically does a China-based issuer that engages an audit firm based in China or Hong Kong address:
  - the continued inability of the PCAOB to inspect the audit work of its outside auditor and whether this has been taken into account by the company's audit committee in connection with its oversight of the outside auditor;
  - the difficulty the SEC and PCAOB may have in obtaining audit work papers from the company's outside auditors and the company, and how that may affect the company and its shareholders;
  - the possibility of the SEC initiating proceedings against the company's outside auditors that could result in penalties being imposed against the audit firm;
  - limitations imposed by Chinese authorities on the ability of U.S. regulators to conduct investigations; and
  - the possibility that U.S. legislative or other regulatory actions could result in delisting of the company from a U.S. stock exchange on which the company is currently listed, which in turn could affect liquidity or trading prices of the securities listed in the United States.
- Does the company use VIEs in its organizational structure? If so, does the company include sufficient disclosure about the related party transactions in the VIE structure and caution investors about the risks associated with the VIE structure? Does the company caution investors about:
  - the possibility of Chinese authorities declaring the VIE structure inconsistent with applicable laws or Chinese tax authorities disregarding the structure resulting in increased tax liabilities;
  - the potential limited effectiveness of the VIE structure in terms of control as compared to direct ownership in controlling entities organized in China, which often hold the licenses necessary to conduct the company's business; and
  - the possibility of control over the VIE being undermined if the natural persons that hold the equity interest in the VIE breach the terms of the VIE agreement.
- Does the company disclose risks relating to the regulatory environment in China, including risks related to a less developed legal system, which may result in inconsistent and unpredictable interpretation and enforcement of laws and regulations? Does the company caution investors about:
  - evolving laws and regulations and inconsistent enforcement that could result in the company's inability to obtain or maintain license or permits;

- the potential for Chinese authorities to adopt more stringent standards concerning environmental and social issues that may adversely impact the company's operations;
- insufficient intellectual property rights and protections for the company's material intellectual property in China;
- potential unfavorable tax consequences for non-citizen shareholders of the company;
- uncertainties related to the Chinese legal system that could limit enforcement of contractual arrangements or restrict certain foreign investments in China;
- the ability of Chinese authorities to control currency conversion and impose restrictions on funds transfers into or out of China; and
- Chinese authorities' discretion in influencing how the company conducts its business operations.

- Does the company provide risk disclosure about differing shareholder rights and remedies in the company's country of organization and/or based on where the company's operations are located? These include the difficulties in effecting the service of process, enforcing judgments and bringing claims against China-based issuers as well as the lack of established shareholder rights and protections.
- Does the company that is also a foreign private issuer provide disclosures regarding corporate governance differences pursuant to Item 16G of Form 20-F and differences in reporting requirements as compared to U.S. domestic issuers, such as frequency of financial reporting and lack of quarterly reports and proxy solicitations?

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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